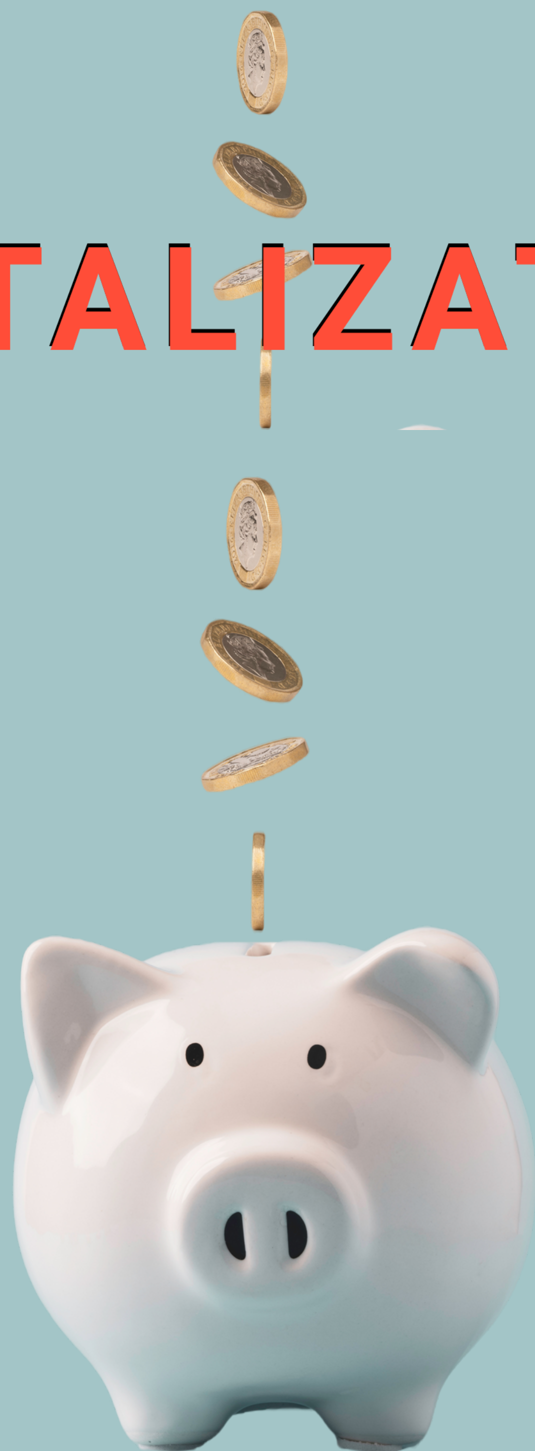
BLOG ARTICLE FOCUS

LAW FIRM
CAPITALIZATION



BLOG ARTICLE

Law Firm Capitalization

PerformLaw
Law Firm Performance Improvement Experts

As law firms strive to maintain competitiveness and relevance, understanding the principles of law firm capitalization becomes imperative. Mature firms who have the discipline to implement a capitalization policy are better able to manage debt, take more strategic risks and enjoy more financial stability.

Law firm capitalization serves as the bedrock upon which a firm's growth, innovation, and client service stand.

In this series, we delve into the intricacies of law firm capitalization, exploring its multifaceted components, strategic implications, and real-world applications. Join us as we unravel the layers of effective capitalization, examining its role in sustaining operational efficiency and long-term success.

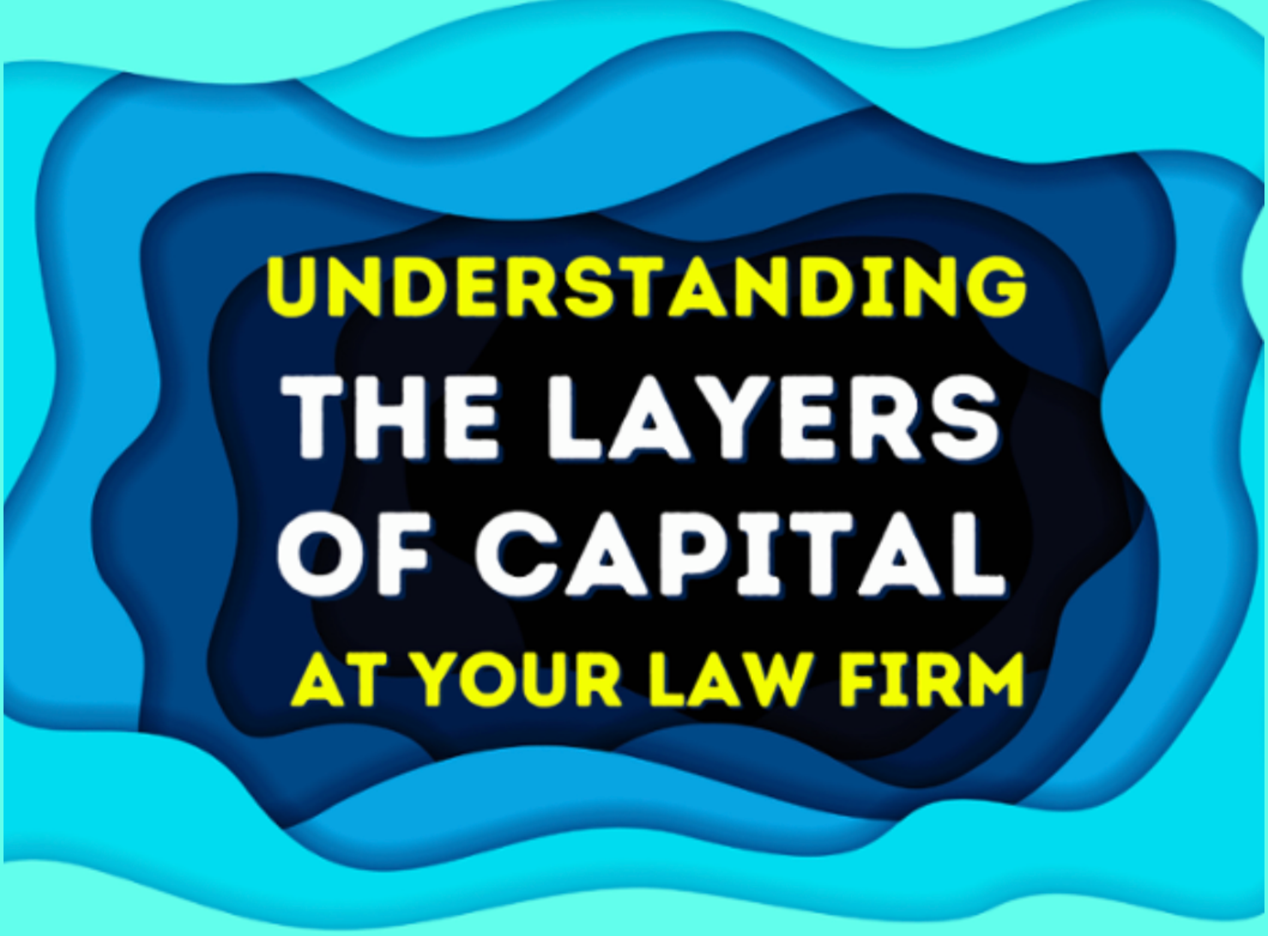
Blog Article: ***Law Firm Capitalization***

Paid-in capital is crucial in keeping a law firm financially stable and growing. It's usually contributed through cash but can also involve real property, unbilled time, and accounts receivable from a former firm. The amount of paid-in capital may differ based on firm size, billing cycles, draw policy, and firm maturity. For example, a startup usually requires more capital than an established firm.

The financial capability of the equity owners also plays an essential role in determining how much permanent capital the firm can sustain. Older partners can usually contribute more due to accumulated wealth over time, while newer partners might bring in more profit and demand a higher ownership stake but still need to accumulate liquid assets (savings). Knowing the significance and factors of paid-in capital can help maintain a law firm's success.

Attention law firms! When it comes to capital structure, paid-in capital is only sometimes part of the story. New and younger firms often rely on debt (line of credit) and personal guarantees from owners to get off the ground. But to ensure financial stability, we recommend having at least two months' worth of operating expenses in paid-in capital. For example, a firm with a $100K monthly expense load and owners' draw outlay would need $200K in total capital. Reaching this level may take a few years if you are a new firm.

Law firms should not underestimate the importance of planning now for future capitalization needs. A solid plan to build up paid-in capital is critical for financial stability and security. Without sufficient money, law firms may be more vulnerable to economic downturns and other external factors that could put them at risk of running out of cash. Running out of cash significantly increases the chance that a law firm will fail.

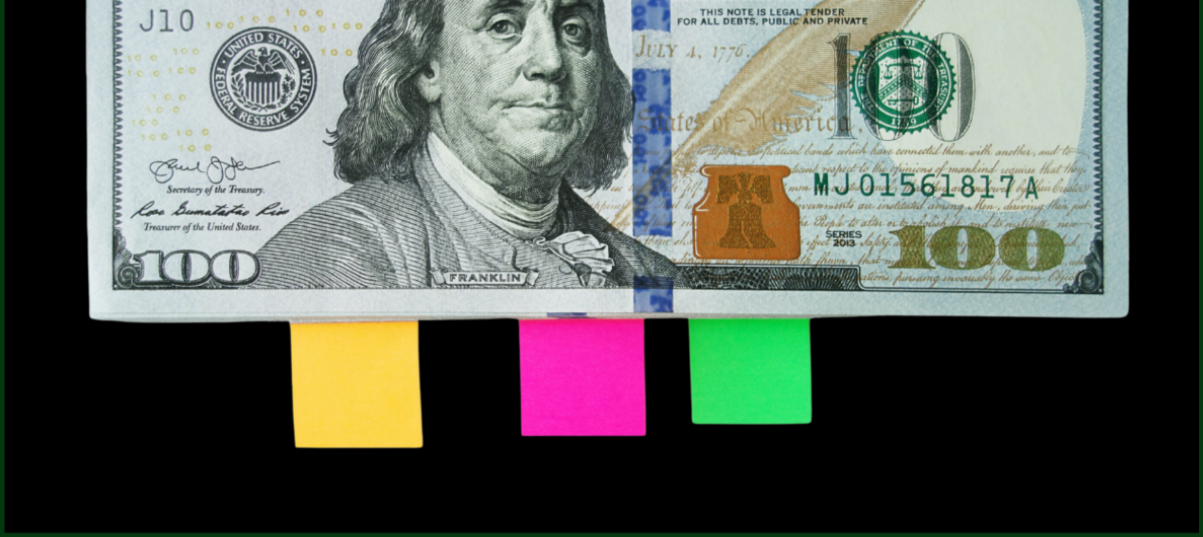


For law firms, undistributed earnings refer to current-year profit earned by equity owners that has yet to be paid to them. These earnings typically, until paid out, serve as a source of working capital for the firm. Withheld earnings, on the other hand, are a more structured approach where a percentage of current-year earnings are held back from distribution as a matter of policy. This potentially provides a less stable long-term source of working capital for the firm. Depending on the hold-back formula, the firm may experience fluctuations in its available capital, which could result in the need for increased borrowing during tough times. Law firms must understand the differences between the capital layers in a typical law firm and use them accordingly.

Taxation can burden owners of law firms that are taxed as partnerships, primarily when excessive capital is held back, or capitalization policy is erratic. This can make it difficult for owners to make estimated tax payments, causing unnecessary financial pressure. However, adequately capitalized firms can avoid this by paying partners on time and ensuring all prior year earnings are paid by April 15th of the following year. This strategy allows owners to receive the cash they need to pay taxes on time, reducing the risk of financial stress.

Law firms often need additional capital when waiting for client payments to cover their current operating expenses. This is where debt, in the form of a line of credit, is often used. Lines of credit can be drawn upon to bridge the gap between client payments and operating expense payments. When the accounts receivable are paid, the line of credit should be reduced. However, law firms that operate on a contingent basis, such as plaintiff firms, encounter unique challenges related to case costs and the unpredictable nature of their cash flows.

In either case, a good rule of thumb is not to use debt to finance partner drawings or distributions, which should only come from excess cash flow. However, it is typical for law firm start-ups to use debt to fund partner draws within three to six months of operation. Responsible use of debt is a part of the capital structure of most law firms.



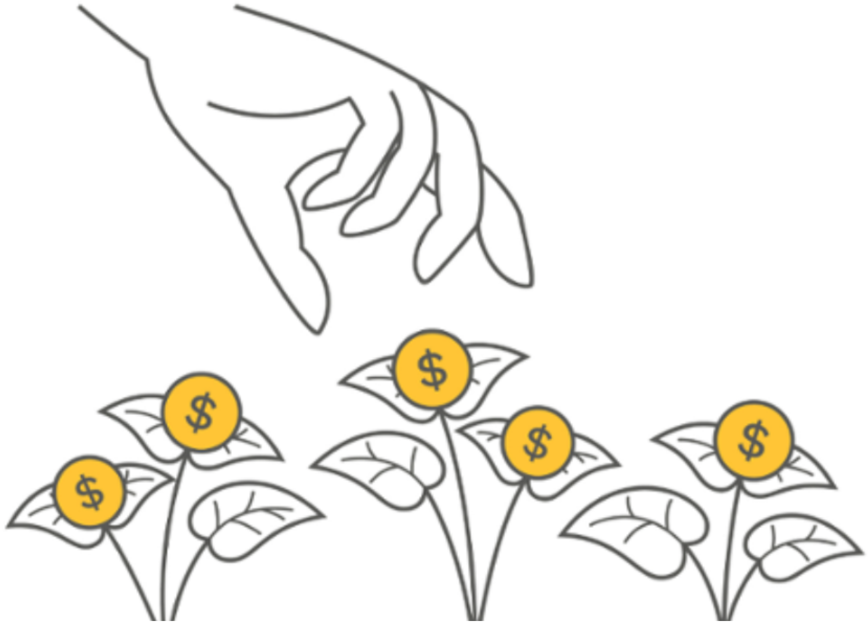
USING TERM NOTES TO ALIGN CASH FLOWS WITH ASSET DEPRECIATION RATES IN LAW FIRMS

Law firms need capital to finance non-operating expenses, including leasehold improvements, furniture, equipment, computers, and other depreciable assets. These assets differ from payroll and office expenses in that they are typically expensed over an extended period. This can create a timing difference between when money is spent and when partner income is reduced.

For example, if a law firm buys new technology, it's unlikely the entire cost will be expensed in one year. Instead, partners may decide to expense the value based on the equipment's useful life. This means only the amount written off in the current year will reduce partner income. As a result, there may be more owner income than available cash for distribution. To address this problem, firms may secure a banknote with a fixed principal repayment and interest rate. Law firms can better align cash flows by aligning debt repayment with asset depreciation rates.

Term notes differ from lines of credit because they require monthly principal and interest payments for a stated duration. Term notes are an essential part of a law firm's capitalization structure.

A BALANCED CAPITALIZATION POLICY TO SECURE YOUR LAW FIRM'S FUTURE



Many law firms use their credit line for longer-term borrowings and as a substitute for paid-in or withheld capital. Adopting a balanced capital policy consisting of permanent capital, withheld earnings, short-term undistributed earnings, and both short and long-term debt can help law firms avoid having the wrong mix of debt and undistributed profits. A planned approach to financing your law firm ensures that cash is available to meet operating expenses timely, invest in tools and equipment, and enable growth.

Law firms with a capitalization policy find more financial stability. They are better able to manage debt and take more strategic risks.

If you have questions or concerns about how your law firm is capitalized and what you can do to improve, PerforLaw is here to help.

Contact Performlaw Today.

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